

7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 742

Regulatory Flexibility Program

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed Rule.

SUMMARY: The National Credit Union Administration (NCUA) seeks public comment on a proposal to modify the minimum net worth and CAMEL criteria for eligibility for NCUA's Regulatory Flexibility Program. Federally-insured credit unions that qualify for the Program are exempt in whole or in part from a series of regulatory restrictions and also are allowed to purchase and hold an expanded range of eligible obligations.

DATES: Comments must be received on or before September 27, 2005.

ADDRESSES: You may submit comments by any one of the following methods (**Please send comments by one method only**):

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.

- NCUA Web Site: http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.
- E-mail: Address to regcomments@ncua.gov. Include “[Your name] Comments on Proposed Rule 742, RegFlex Program” in the e-mail subject line.
- Fax: (703) 518-6319. Use the subject line described above for e-mail.
- Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

FOR FURTHER INFORMATION CONTACT: Steven W. Widerman, Trial Attorney, Office of General Counsel, at 703/518-6557; or Lynn K. Markgraf, Program Officer, Office of Examination and Insurance, at 703/518-6396.

SUPPLEMENTARY INFORMATION:

A. BACKGROUND OF EXISTING PART 742

Effective in 2002, the NCUA Board established a Regulatory Flexibility Program (“RegFlex”) that exempts qualifying credit unions in whole or in part from a series of regulatory restrictions, and grants them additional powers. 12 C.F.R. part 742; 66 FR 58656 (Nov. 23, 2001). Under existing part 742, a credit union may qualify for RegFlex automatically or by application to the appropriate Regional Director.

RegFlex Designation. To qualify automatically under the existing RegFlex Program, a credit union must meet two criteria. First, it must have a composite CAMEL rating of “1” or “2” for two consecutive examination cycles. Second, it also must achieve a net worth ratio of 9 percent (200 basis points above the net worth ratio to be classified “well capitalized”) for a single Call Reporting period, unless it is subject to a risk-based net worth (“RBNW”) requirement. 12 C.F.R. 742.1. In that case, the credit union’s net

worth must surpass its RBNW requirement by 200 basis points. As of December 31, 2004, 3457 credit unions automatically qualified for RegFlex.

Under existing part 742, a credit union that is unable to qualify for RegFlex automatically may be eligible to apply to the appropriate Regional Director for a RegFlex designation. To be eligible to apply, a credit union must have either a CAMEL rating of “3” or better or meet the 9 percent net worth criterion, *but not both*. 12 C.F.R. 742.2. A credit union that neither has a CAMEL of “3” or better nor meets the net worth criterion is ineligible for RegFlex. A credit union that is eligible may be granted RegFlex relief in whole or in part, at the Regional Director’s discretion. In 2004, four out of four applications for a RegFlex designation were granted.

Once attained under current part 742, RegFlex authority can be lost or revoked. A credit union that qualified for RegFlex automatically is disqualified once it fails, as the result of an examination (but not a supervision contact), to meet either the CAMEL or net worth criteria in §742.2(a). 12 C.F.R. 742.6. RegFlex authority can be revoked by action of the Regional Director for “substantive and documented safety and soundness reasons.” §742.2(b). The decision to revoke may be appealed to NCUA’s Supervisory Review Committee,¹ and thereafter to the NCUA Board. 12 C.F.R. 742.7. In 2004, only one credit union’s RegFlex authority was revoked, with no appeal.

RegFlex authority ceases when that authority is lost or revoked (even if an appeal of a revocation is pending). 12 C.F.R. 742.6, 742.7. But past actions taken under that authority are “grandfathered,” i.e., they will not be disturbed or undone.

¹ See Interpretive Ruling and Policy Statement 95-1, 60 FR 14795 (March 20, 1995).

RegFlex Relief. As originally adopted, the RegFlex program gave qualifying credit unions relief from a variety of regulatory restrictions, 12 C.F.R. §§742.4(a) and 742.5:

- The maximum limit on fixed assets (5 percent of shares and retained earnings), 12 C.F.R. 701.36(c)(1).
- The maximum limit on non-member deposits (20 percent of total shares or \$1.5 million, whichever is greater), 12 C.F.R. 701.32(b).
- Conditions on making charitable contributions (relating to the charity's location, activities and purpose, and whether the contribution is in the credit union's best interest and is reasonable relative to its size and condition), 12 C.F.R. 701.25.
- The maximum limit on investments over which discretionary control can be delegated (100 percent of credit union's net worth), 12 C.F.R. 703.5(b)(1)(ii) and (2).
- The maximum limit on the maturity length of zero-coupon securities (10 years), 12 C.F.R. 703.16(b).
- The mandate to "stress test" securities holdings to assess the impact of a 300-basis points shift in interest rates, 12 C.F.R. 703.12(c) (2001).
- Restrictions on the purchase of eligible obligations, 12 C.F.R. 701.23(b), thus expanding the range of loans RegFlex credit unions could purchase and hold as long as they are loans those credit unions would be authorized to make (auto, credit card, member business, student and mortgage loans, as well as loans of a liquidating credit union up to 5 percent of the purchasing credit union's unimpaired capital and surplus).

With the overhaul of parts 703 and 723 in 2003,² RegFlex credit unions received further relief from the following restrictions on member business lending and investments:

- The mandate that principals personally guarantee and assume liability for member business loans. 12 C.F.R. 723.7(b).
- The maturity limit on investments purchased with the proceeds of a borrowing repurchase transaction. 12 C.F.R. 703.13(d)(3).
- The prohibition on purchasing a commercial mortgage related security that is not permitted by the Federal Credit Union Act, 12 U.S.C. 1757(7)(E). 12 C.F.R. 703.16(d).

² See 68 FR 32960, 32966 (June 3, 2003) and 68 FR 56537, 56542, 56553 (Oct. 1, 2003).

B. PROPOSAL TO MODIFY REG FLEX QUALIFYING CRITERIA

The NCUA Board is reassessing the RegFlex program to ensure that it is available to credit unions that are least likely to encounter safety and soundness problems, thus minimizing the risk of loss to the Share Insurance Fund. Experience indicates that such credit unions consistently maintain a high net worth ratio and a high CAMEL rating. Accordingly, the proposed rule modifies the RegFlex eligibility criteria to fully reflect sustained superior performance as measured by net worth and CAMEL rating.

Net worth level. To qualify for RegFlex automatically or by application, existing part 742 requires a credit union to achieve a net worth of 9 percent—200 basis points in excess of the 7 percent net currently needed to be classified “well capitalized.”³ The proposed rule brings the net worth criterion for RegFlex into alignment with the “well capitalized” net worth category under NCUA’s system of prompt corrective action (“PCA”). 12 U.S.C. 1790d(c)(1)(A). Congress determined that it is unnecessary for credit unions in that category—the highest of the five net worth categories—to undertake any PCA whatsoever. The NCUA Board believes there is no reason to set a higher net worth standard to qualify for RegFlex than Congress has set for credit unions to be free of PCA. Accordingly, the proposed rule reduces the qualifying minimum net worth classification to “well capitalized,” requiring a minimum net worth of 7 percent under

³ December 2004 Call Report data indicates that 73 percent of all RegFlex credit unions have a net worth in excess of 11 percent—fully 200 basis points above the qualifying minimum net worth. In contrast, only 8.9 percent of RegFlex credit unions have a net worth of 9.5 percent or less—within fifty basis points of the qualifying minimum net worth.

existing part 702.⁴ Credit unions that are subject to an RBNW requirement would qualify for RegFlex if they remained “well capitalized” after applying any RBNW requirement applicable under part 702.

Net worth duration. To qualify for RegFlex, existing part 742 requires a credit union to achieve the minimum net worth for just a single quarter. This momentary “snapshot” of net worth is too fleeting to be evidence of sustained superior performance; only successive “snapshots” of net worth would suffice to demonstrate such performance. To that end, the proposed rule requires a credit union to meet a dual standard: to be “well capitalized” and to maintain that level for six consecutive quarters. The six-quarter period coincides with the eighteen-month examination schedule that applies to most RegFlex qualifying credit unions. A credit union that is unable to maintain the minimum net worth for six consecutive quarters still would be eligible to apply to the appropriate Regional Director for a RegFlex designation provided the credit union is rated a CAMEL “2” or better.

The proposed rule strikes a balance—decreasing the minimum net worth while compensating for the relative increase in risk exposure by extending the number of quarters that the minimum net worth must be maintained to qualify for RegFlex. For example, there is no limit on the amount of fixed assets a RegFlex credit union can acquire. 12 C.F.R. 742. 4(a). Thus, a RegFlex credit union is entitled to build or purchase a new building that increases its aggregate fixed assets to an inordinate proportion of total assets. If the credit union no longer qualifies for RegFlex in the next

⁴ Should the minimum net worth to be classified “well capitalized” under PCA be adjusted by law, or as permitted by law, 12 U.S.C. 1790d(c)(2), the minimum net worth to qualify for RegFlex would change accordingly.

quarter due to a decline in net worth, the “grandfather” provision in both the existing and the proposed rule would leave intact all actions formerly taken under RegFlex authority. 12 C.F.R. 742.8. That provision would entitle the ex-RegFlex credit union to keep the building, provided that it absorbs the expenses of maintenance, debt service and depreciation, etc., potentially having a negative affect on its profitability and net worth.

Under the existing rule, the ex-RegFlex credit union would have a net worth cushion of at least 300 basis points against possible losses due to expenses of maintaining its fixed assets.⁵ But under the proposed rule, the net worth cushion against such losses dwindles to zero. Credit unions that demonstrate sustained superior performance as evidenced by a qualifying net worth ratio lasting over a series of quarters, instead of just one, are better able to prepare for and manage the risks to profitability and net worth. The NCUA Board invites public comment on what is the appropriate number of quarters the minimum net worth should be required to last before a credit union qualifies for RegFlex.

Notification. Existing part 742 requires NCUA to notify a credit union on three occasions: when it first qualifies automatically for RegFlex; during an examination to confirm whether it still qualifies or has become ineligible; and after it applies to the appropriate Regional Director for a RegFlex designation. These notification requirements are redundant in the case of credit unions that qualify automatically for RegFlex. Part 742’s net worth and CAMEL criteria are discrete and as apparent to credit unions themselves as to NCUA, making it unnecessary for NCUA to notify each credit union that it has qualified for RegFlex, and then to notify it again during successive

⁵ A net worth ratio of 6.99 percent or lower triggers the PCA requirement to make quarterly transfers of earnings to net worth. 12 U.S.C. 1790d(e); 12 C.F.R. 702.201(a). A net worth ratio of 5.99 percent or

examinations that it still qualifies. Accordingly, the proposed rule eliminates the requirement that NCUA notify credit unions that qualify automatically for RegFlex. But left intact is the requirement for a Regional Director to notify a credit union that has applied for RegFlex designation whether or not it has been granted.

Other modifications. The substantive modifications to part 742 are limited to reducing the level and extending the duration of the minimum qualifying net worth, and eliminating the notification requirement for credit unions that qualify automatically for RegFlex. No substantive revisions at all are proposed for the RegFlex relief (fully described in section A. above) that existing part 742 provides qualifying credit unions. 12 C.F.R. 742.4. However, the NCUA Board invites public comment on whether RegFlex credit unions should be exempt from any additional regulations.

To make part 742 more user-friendly, the proposed rule makes several fundamental changes to the existing format. First, the proposed rule abandons the question-and-answer format in favor of organizing the rule by stated subjects. Second, in several provisions of the rule, items listed within narrative text have been broken out into numbered and subtitled lists that make individual items more accessible. E.g., 12 C.F.R. 742.2. Finally, in the section on RegFlex relief, instead of incorporating the affected regulations simply by reference to other sections of chapter VII, the proposed rule lists and describes the regulatory requirements and restrictions that RegFlex credit unions are exempt from, as well as the obligations they are authorized to purchase and hold. 12 C.F.R. 742.4.

Impact on Credit Unions. Were the NCUA Board to adopt the proposed substantive modifications, December 2004 Call Report data shows that 3,919 credit

below triggers all four PCA mandatory supervisory actions. 12 U.S.C. 1790d(f)-(g); 12 C.F.R. 702.202(a).

unions would qualify for RegFlex automatically—a 13.36 percent increase over the number of credit unions that qualify under existing part 742. Further, the proposed modifications would make an additional 462 credit unions that do not automatically qualify eligible to apply for a RegFlex designation.

REGULATORY PROCEDURES:

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis describing any significant economic impact a proposed regulation may have on a substantial number of small credit unions (those having under \$10 million in assets). The proposed rule reduces the level and increases the duration of the minimum net worth required to qualify for RegFlex, without imposing any additional regulatory burden. If adopted, the proposed rule will not have a significant economic impact on a substantial number of small credit unions. Thus, a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

NCUA has determined that the proposed rule would not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on State and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily adheres to the fundamental federalism principles addressed by the executive order. This proposed rule would not have would not have a substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Accordingly, this proposed rule does not constitute a policy that has federalism implications for purposes of the Executive Order.

Treasury and General Government Appropriations Act, 1999

NCUA has determined that the proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

Agency Regulatory Goal

NCUA's goal is to promulgate clear, understandable regulations that impose a minimal regulatory burden. The proposed rule seeks to improve and simplify the existing RegFlex Program. We request your comments on whether the proposed rule would be understandable and minimally intrusive if implemented as proposed.

List of Subjects

12 CFR Part 742

Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on July 21, 2005.

Mary F. Rupp
Secretary of the Board

For the reasons set forth above, 12 CFR part 742 is proposed to be revised as follows:

PART 742 – REGULATORY FLEXIBILITY PROGRAM

Authority: 12 U.S.C. 1756, 1766.

§742.1 Regulatory Flexibility Program.

NCUA's Regulatory Flexibility Program (RegFlex) exempts from all or part of the NCUA regulatory restrictions identified elsewhere in this part credit unions that demonstrate sustained superior performance as measured by CAMEL rating and net worth classification. RegFlex credit unions also are authorized to purchase and hold an expanded range of obligations.

§ 742.2 Criteria to qualify for RegFlex designation.

(a) Automatic qualification. A credit union automatically qualifies for RegFlex designation, without formal notification, when it has:

(1) CAMEL. Received a composite CAMEL rating of “1” or “2” for the two
(2) preceding examinations; and

(2) Net worth. Maintained a net worth classification of “well capitalized” under part 702 of this chapter for all six (6) preceding consecutive quarters or, if subject to a risk-based net worth (RBNW) requirement under part 702 of this chapter, has remained “well capitalized” for all six (6) preceding consecutive quarters after applying the applicable RBNW requirement.

(b) Application for designation. A credit union that does not automatically qualify under paragraph (a) of this section may apply for a RegFlex designation, which may be granted in whole or in part upon notification by the appropriate Regional Director, if the credit union has either:

(1) CAMEL. Received a composite CAMEL rating of “3” or better for the preceding examination; or

(2) Net worth. Maintained a net worth classification of “well capitalized” under part 702 of this chapter for less than all six (6) preceding consecutive quarters or, if subject to an RBNW requirement under part 702 of this chapter, has remained “well capitalized” for less than all six (6) preceding consecutive quarters after applying the applicable RBNW requirement.

§ 742.3 Loss and Revocation of RegFlex designation.

(a) Loss of Authority. RegFlex authority is lost when a credit union that qualified automatically under the CAMEL and net worth criteria in §742.2(a) no longer

meets either of those criteria. Once the authority is lost, the credit union may no longer claim the exemptions and authority set forth in §742.4.

(b) Revocation of authority. The Regional Director may revoke a credit union's RegFlex authority under §742.2, in whole or in part, for substantive and documented safety and soundness reasons. When revoking RegFlex authority, the regional director must give written notice to the credit union stating the reasons for the revocation. The revocation is effective upon the credit union's receipt of notice from the regional director.

(c) Appeal of revocation. A credit union has 60 days from the date of the regional director's determination to revoke RegFlex authority to appeal the action, in whole or in part, to NCUA's Supervisory Review Committee. The Regional Director's determination will remain in effect unless and until the Supervisory Review Committee issues a different determination. If the credit union is dissatisfied with the decision of the Supervisory Review Committee, the credit union has 60 days from the date of the Committee's decision to appeal to the NCUA Board.

(d) Grandfathering of past actions. Any action duly taken in reliance upon RegFlex authority will not be affected or undone by subsequent loss or revocation of that authority. Any actions exercised after RegFlex authority is lost or revoked must comply with all applicable regulatory requirements and restrictions. Nothing in this part shall affect NCUA's authority to require a credit union to divest its investments or assets for substantive safety and soundness reasons.

§742.4 RegFlex Relief.

(a) Exemptions. RegFlex credit unions are exempt from the following regulatory restrictions:

(1) Charitable contributions. §701.25 of this chapter concerning charitable contributions;

(2) Nonmember deposits. §701.32(b) and (c) of this chapter concerning the maximum amount of non-member deposits a credit union can accept; and

(3) Fixed assets. §701.36(a), (b) and (c) of this chapter concerning the maximum amount of fixed assets a credit union can acquire;

(4) Member business loans. §723.7(b) of this chapter concerning the personal liability and guarantee of principals for member business loans.

(5) Discretionary control of investments. §703.5(b)(1)(ii) and (2) of this chapter concerning the maximum amount of investments over which discretionary control can be delegated;

(6) “Stress testing” of investments. §703.12(c) of this chapter concerning “stress testing” of securities holdings to assess the impact of an extreme interest rate shift;

(7) Zero-coupon securities. §703.16(b) of this chapter concerning the maximum maturity length of zero-coupon securities;

(8) Borrowing repurchase transactions. §703.13(d)(3) of this chapter, concerning the maturity of investments a credit union purchases with the proceeds received in a borrowing repurchase transaction, provided the value of the investments that mature later than the borrowing repurchase transaction does not exceed 100 percent of the federal credit union's net worth;

(9) Commercial mortgage related security. §703.16(d) of this chapter prohibiting the purchase of a commercial mortgage related security that is not otherwise permitted by 12 U.S.C. 1757(7)(E), provided:

(i) The security is rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization;

(ii) The security meets the definition of mortgage related security as defined in 15 U.S.C. 78c(a)(41) and the definition of commercial mortgage related security as defined in §703.2 of this chapter;

(iii) The security's underlying pool of loans contains more than 50 loans with no one loan representing more than 10 percent of the pool; and

(iv) The aggregate total of commercial mortgage related securities purchased by the Federal credit union does not exceed 50 percent of its net worth.

(b) Purchase of obligations from a FICU. A RegFlex credit union is authorized to purchase and hold the following obligations, provided that it would be empowered to grant them:

(1) Eligible obligations. Eligible obligations pursuant to §701.23(b)(1)(i) of this chapter without regard to whether they are obligations of its members,

provided they are purchased from a federally-insured credit union only;

(2) Student loans. Student loans pursuant to §701.23(b)(1)(iii) of this chapter, provided they are purchased from a federally-insured credit union only;

(3) Mortgage loans. Real-state secured loans pursuant to 701.23(b)(1)(iv) of this chapter, provided they are purchased from a federally-insured credit union only;

(4) Eligible obligations of a liquidating credit union. Eligible obligations of a liquidating credit union pursuant to §701.23(b)(1)(ii) of this chapter without regard to whether they are obligations of the liquidating credit union's members, provided that such purchases do not exceed 5 percent (5%) of the unimpaired capital and surplus of the purchasing credit union.